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The impact of financial liberalisation on the performance of banks in Nigerian

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Abstract

Interest rate liberalisation as part of financial sector reforms was assessed as it affects the performance of banks that experienced the first phase of the Nigerian's liberalisation policy. The paper examines whether the financial performance of the banks improved after the liberalisation policy. The wilcoxon signed rank test was used to test for changes in the following performance measure variables; profitability, deposit lending and operating efficiency. Therefore, the results of the study lend support to the proposition that banks in Nigeria witnessed performance improvement following government's liberalisation programme.

Keywords: liberalisation, efficiency, performance,policy;

1. Introduction

The financial sector boom was accompanied by financial dis-intermediation, with deposits in financial institutions and credit to the private sector, which were both relative to GDP, and as a result there was a decrease over the period 1986 to 1992. The increasing number of banks and human capital in the financial sector was thus channelled into arbitrage and rent-seeking activity rather than financial intermediation (Jerome *et al,* 2003:7).

Political economy explanations of the liberalization and boom-and-bust period focus on rent-seeking activities of the governing elites (Lewis and Stein, 2002). While moving forward with structural reforms in many areas, liberalization measures were selective to maintain patronage opportunities and to insulate the governing elites and their supporters from the economic costs of these reforms. The expanding financial sector and the new arbitrage possibilities through the multi-tiered exchange rate system offered numerous patronage opportunities for political and military leaders. Bank licensing was a politically influenced process and managing boards of banks included many politicians and senior military officers. However, the shift of arbitrage and rent-seeking activities from the real to the financial sector – further fostered by macroeconomic instability – also created new groups of wealth and economic power, (Jerome, 2003:8).

Through the removal of the elements of financial repression, particularly controlled interest rates, financial sector reform is expected to lead to higher nominal and real interest rates. This is the postulate of the hypothesis (Mckinnon 1973; Shaw 1973). A higher real interest rate encourages people to substitute consumption for savings (the substitution effect). On the other hand, the higher interest income on savings makes savers to achieve their saving targets with lower stock of savings (the wealth or income effect). The two effects operate in opposing directions and the net outcome would depend on which one that dominates. The underlying logic of the Mckinnon-Shaw doctrine is that the substitution effect would outweigh the wealth effect. Financial savings will further be

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boosted by a shift in the savers wealth portfolio from non-financial assets to financial assets (asset substitution effect).

A feasible sequence of financial liberalization is set out in underscores the need to restore macroeconomic and financial stability before the commencement of large-scale financial liberalization. Pursuing macroeconomic stability will involve dampening inflationary pressures through a reduction in fiscal deficits and the tightening of monetary and credit policies.

In the context of the Structural Adjustment Program (SAP) in 1986, Nigeria undertook a broad program of financial liberalization. Interest rates and entry into the banking system were liberalized, and credit allocation quotas loosened. At the same time, while ending direct rationing of foreign exchange for the real sector, the government maintained a multiple exchange rate regime, thus opening a new era of arbitrage and rent seeking for financial institutions that had privileged access to foreign exchange auctions (Jerome *et al,* 2003:6). This resulted to the quick entry of many new players into the banking system, especially merchant banks. In the following years, the number of banks tripled from 41 to over 120, employment in the financial sector doubled and the contribution of the financial system to GDP almost tripled (Lewis and Stein, 2002).

This paper therefore, examines whether the financial and operating performance of the banks improved after liberalisation programme, and the rest of the paper is structured into five sections. Section 2 provides a brief summary of banks' performance literature and the main findings of previous research studies. The methodology is described in Section 3, and in Section 4 we explain the results and Section 5 concludes the paper.

LITERATURE REVIEW

The financial sector in Nigeria is made up of a wide array of institutions and instruments. It consists of the Central Bank of Nigeria which is the apex financial institution, deposit money banks, Development Finance Institutions, Thrift and Insurance organisations, a Stock exchange and a Securities and Exchange Commission and a virile informal financial sector. Ikhide 1996, observes that prior to the commencement of the structural adjustment programme, the ownership structure of the share capital in commercial banks indicated dominant ownership by government (Federal and State) accounting to 58.6 per cent followed by private shareholders (22.5 per cent) and foreign interests (18.9 per cent). He also made reference to the pattern of investment as at that time to be concentrated in 'other assets' followed by loans and advances and inter- bank placements while commercial banks concentrate on the retail end of the financial system, merchant banks are supposed to transact wholesale banking business.

With the onset of Structural adjustment programme, specialised banks have been established to meet up with the ever increasing credit needs of segments of the society who are not adequately catered for by the existing arrangement. These are the Community banks whose capital requirements are provided by the communities in which they are located and the Peoples Bank which is supposed to provide for the needs of small and medium scale entrepreneurs in the society. Both of them are designed to provide credit facilities at grassroots level and thereby promote self- reliance. Apart from these major financial institutions, the financial system is also inundated by a collection of young and small institutions that play a major role in the intermediation process. These include finance companies, leasing companies, mortgage, savings and loan associations and venture capital companies. Most of these have come into prominence in the wake of the financial innovation that pervaded the system with the onset of financial liberalisation. Although their activities are mainly restricted to the urban areas, their characteristic single unit offices and share aggressiveness in the mobilisation of savings and the creation of investment outlets mark them out as viable potentials for the fostering of enhanced intermediation given a well -developed money and capital market.

Attempts at reforming the financial sector in Nigeria have captured five main headings - reform of the financial structure, monetary policy reforms, foreign exchange reforms, liberalisation of capital movement and capital market reforms. This reform of the financial structure is designed measures undertaken to increase competition, strengthen the supervisory role of the regulatory authorities and strengthen public sector relationship with the financial sector. Such as enhancing bank efficiency through increased competition and management by granting licenses to more banks to operate and alongside with the introduction of an auction-based system for the issuance of treasury certificates aimed at promoting a greater reliance on market forces in the determination of yields on government debts instrument through market determined interest rates and the decision by the Federal government to sell its share-holdings in some commercial and market banks thereby reverting such banks to private ownership.

In line with the policy of financial sector liberalisation that accompanied the Structural Adjustment Programme (SAP) in the second half of the 1980s, the CBN embarked on the transition process from direct to indirect techniques of monetary management. The adoption of the indirect mechanism required interest rate policy to become the most important instrument of monetary management, aimed at regulating the cost of credit by deposit money banks, with the minimum rediscount rate (MRR) as the nominal anchor for all money market interest rates. The purpose of varying the interest rate is to alter the demand for and supply of financial assets in the direction that is consistent with the overall objectives of monetary policy, including output growth and inflation.

A partial deregulation of interest rates was attempted, but by August, all rates became market determined. The CBN adopted the system of fixing only its minimum rediscount rate to indicate the desired direction of interest rates changes. Interest rate liberalisation was aimed at enhancing the ability of banks to charge market-based loans rates and also guarantee the efficient allocation of scarce resources. In 1989, banks were encouraged to pay interest on current account deposits. The rate to be paid was to be negotiated between banks and their customers.

In Tunisian banking sector after liberalisation no significant efficiency improvement have been observed but private owned banks were turned out to be more efficient than the public sector banks [Cook, Moez and Gordon (2001). Therefore based on the past researchers views, the benefits of financial liberalization can therefore be grouped into increased access to domestic and international capital markets and increased efficiency of capital allocation. However critics of financial liberalization policies have contended that the efficient markets concept is fundamentally misleading when applied to capital flows.

In countries with poor corporate governance and low legal protections, there is no reason to think that financial liberalization, either domestic or international, will be welfare improving (Stiglitz, 2000). Furthermore, in countries where the capacity to honour contracts and to assemble information relevant to financial transaction is least developed, there can be no assumption that capital will flow into uses where its marginal product exceeds its opportunity cost. Stiglitz (1994) argues in favour of certain forms of financial repression.

Although Sobodu and Akiode (1998) assess the performance of Nigerian commercial banks over the period 1983-1993 using data envelopment analysis. They find an initial improvement in performance right after the beginning of financial liberalization in 1986 and a steady decline thereafter. Their sample period, however, does not allow them to test the effect on banks. Jerome *et al.* (2003), document significant improvement in the performance of Nigerian banks, with return on assets, return on equity and non-performing loan as the performance indicators. Therefore, this study will complement the literature on bank performance by considering other performance indicators of banks, such as interest on deposits and lending rates and management of banks.

METHODOLOGY FOR THE STUDY

The methodology used in this paper incorporates statistical charts on the interest rate and tables on the overall performance of banks which was culled from the central bank of Nigeria data chart. This helps to identify the impact on liberalisation on interest rates and banks performance. The measures we use are, mainly, those from Muhammed 2004, (in addition to some of those from Verbrugge, Megginson, and Owens (1999). More precisely, to identify the performance changes in our sample banks following the liberalisation, we evaluate the following common bank performance indicators:

Table 1: Testable Predictions and Empirical Proxies Employed in the Study

S/N	Variables	Proxies	Testable predictions
1	Profitability	Return On Turnover = Net Income / Turnover	$ROT_A > ROT_B$
		Return On Assets = Net Income / Total Assets	$ROA_A > ROA_B$
		Return On Equity = Net Income / Total Equity	$ROE_A > ROE_B$
2	Operating Efficiency	Turnover Efficiency = Operating Cost / Turnover	TURLEFF < TUREFF
		Net Income Efficiency = Operating Cost /Net Income	NIEFF < NIEFF
		Common Equity Efficiency = Operating Cost/ Equity	COEQEFE < COEQEFE
3	Deposit rate	Dividend To Turnover = Dividend / Turnover	DIVTUR > DIVTUR
		Dividend Payout = Cash Dividend / Operating Income	DIVPOT > DIVPOT
4	Lending rate	Turnover To Total Assets = Turnover / Total Assets	TURTA > TURTA
		Loans efficiency = Loan losses to Loans	LOLS > LOLS
5	Capital Investments	Capital Expenditure To Turnover = Capital Expendt./ Turnover	CETUR > CETUR
		Capital Expenditure To Total Assets = Capital Exp. / Total Assets.	CETA > CETA

To test these predictions, we first computed empirical proxies for the banks for ten-year period. Five years (2000 - 2004) before and five year (2006 –2009)after the consolidation of banks in Nigeria. This excludes the year of consolidation which is (2005). We used the signed rank test and comparative analysis of tabulated data for testing significant changes in the variables for the banks used as the sample. This procedure tests whether the mean difference in variable values between the pre and post consolidated sample is zero.

4.0 ANALYSIS OF RESULTS

4.1 In this section, we present and discuss our empirical results on the impact of financial liberalisation on the performance of banks in Nigerian. Table 2 below; present a summary of the results from the statistical tables from interest rates of savings and lending between the pre-and post -consolidation of banking reforms. The table represent all the information from the banks which the data is captured as weighted average of deposit and lending rates of the deposit money banks.

Table 2:Weighted Average Deposit and Lending Rates of Commercial Bank

YEAR	INT SAVINGS	PRIME L/RATE	MAX.L/RATE
2000	5.29	17.98	21.55
2001	5.49	18.29	21.34
2002	4.15	24.85	30.19
2003	4.11	20.71	22.88
2004	4.19	19.18	20.82
2005	3.83	17.95	19.49

2006	3.14	17.26	18.70
2007	3.55	16.94	18.36
2008	2.84	15.14	18.70
2009	2.94	18.36	22.90
2010	2.21	17.59	22.51

Source: Central bank of Nigeria. Universal Banking was adopted in 2001. Commercial and merchants banks became deposit money banks(DMBs)

The table above shows the fluctuation of interest rates of both saving, deposits and lending rates. The data indicates that interest rates on savings before the banking reforms was favourable to the saver but post period of the banking reform declined due to different economic conditions that affected the banks. On the other hand the lending rates at its maximum had in the year of recapitalization of banks from 1 billion to 2billion. Lending rates in the event of consolidation of banks had no change from its kind of movement. Therefore liberalisation had brought regulation to interest rate activities.

Based on the aforementioned it is clear that Banks not subjected to interest rate controls which meant that, the control which they had on to offer on deposits per annum and controlled percentage charges per annum on loans had been withdrawn.

From the data source by Muhammed, (2004), on the privatization of banks in Nigeria, he reported a non-significant change on the performance of banks due to change of board of directors. From his studies, a change in management of some banks in 2010 had brought an impact on the part of the affected banks.

4.2 Profitability and Investment Changes

The profit after tax of banks after the consolidation shows a remarkable improvement as banks have group accounts and banks account. Since the now bigger banks are with subsidiary companies of insurance, discount houses, bureau d change. profitability analysis was used by adopting the indicators of economic measurement of financial sector. The table below shows the banks indicator on economic review.

Before the period of consolidation, most banks had investments in other sectors of the economy. But with the upcoming of recapitalisation exercise, the banks had to withdraw and liquidate these investments so as to meet the required capital base of N25 billion. These were done through IPO, or through merger between two or banks or by outright acquisition of bigger stronger banks. This requirement made the banks pull out their investments in other businesses so as to meet up with the required capital base and in the same vain expanding through subsidiary companies in line with banking business

Table 2. Banks Performance Indicators as at 2010

	2010(N’B)	**2009(N’B)**	**2008(N’B)**	**2007(B’N)**	**2006(B’N)**
Banks Total Asset	18,374	15,851	17,031	10,431	6,738
Banks Non-perf loan%	-	35.00	6.53	8.44	8.76
Total Banks Deposit	-	4,077	5,475	5,358	3,441

Time deposit%	7.22	11.69	11.78	9.47	8.28
Prime Lending Rate %	16.98	18.67	16.01	16.94	16.92

Source. Nigerian economic and financial market review report

(FSDH, 2011) analysed the distribution of banks deposits to be in four dimension. In demand deposit which is 41%, term deposit to be 30%, savings to be 13% while others 3% in 2010.

Efficiency changes

Based on the afore mention it is clear that with banking reforms and recapitalisation of banks excersice there is an upward change in terms of efficiency on the financial sector.

4.3 Changes in the composition of board of directors and chief executive officers

Muhammed,(2008) finds that 10 banks witnessed a marked turnover of more than 50% in the composition of their board of directors. Which the changes indicates the significant improvement to be documented in the financial and operating performance of the privatised banks and that the change is expected to be accompanied by improvement in the institutional conditions of the banks, which include a reduction in political and bureaucratic intervention by the government, promotion of profit maximizing behaviour by the board, and enhancement of managerial autonomy.
Apart from the significant changes in the operating and financial characteristics, some banks witness marked turnover among in the members of board of directors and chief executives due to increase in paid up capital through Initial public offerings while others due to merger or acquisition or both .

SUMMAY AND CONCLUSION

This study compares the pre and post consolidation impact on financial liberalisation on banks performance in Nigeria and had experienced and survives the banking consolidation exercise in 2005. The study observed the lending and deposit movement for the period of ten years (Post and Pre era). The financial and operating performances of the banks were measured in terms of efficiency and profitability. The study documented significant increases in the mean levels of profitability, and operating efficiency. The study shows the liberalisation policy on banks had a significant impact even after the banking consolidation exercise. In order to determine the factors that are responsible for the success of the banking reforms of 2005 in Nigeria, made analysis into whether the banks changed their chief executives after or not and whether the composition of the board of directors remain as it were before the exercise. Most of the merged or fully acquired by stronger asset based banks witnessed a marked turnover in the composition of their board of directors after consolidation. Therefore, the study lend support for liberalisation of banks as its impact had increase the performance banks in Nigeria. The liberalisation policy has fit to reformation policy of the financial sector.

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